Lecture Text

Stephen P. Bradley

Capturing the Value:
Competitive Strategies that Work

(*edited for clarity*)

Introduction
What I want to do in the next hour is to give you an overview of competitive strategy. This will hit the high points of our framework for analyzing competitive strategies of firms. And I call it "Capturing the Value" because that's the idea: to get out and apply this kind of framework and capture the value in your marketplace.

Components of Corporate Strategy
Let me begin by talking a little bit about corporate strategy. And I can illustrate corporate strategy by this diagram, where I break it up into these four components: the purpose, the core competencies, the scope, and the business unit strategies.

Purpose
The first question I have is about the purpose. It talks about corporate vision, values, and goals. Do values play a role in strategy? What's the role that values play? Gives some meaning to what you're doing. What else?

__: Well, if you look at Apple, a lot of their problem was their values . . .

PROFESSOR BRADLEY: Right. The impediments to changing their strategy were their corporate values, corporate culture. But there are a number of examples where you see values play an important role. They play an important role in automatically implementing and executing your strategy without a lot of discussion. So a lot of things can get simplified if you're all on the same page with the values.

A classic example would be Johnson & Johnson, when they had the Tylenol scare, when people were poisoning Tylenol pills. How long did it take Johnson & Johnson to pull the product from the market? Less than twenty-four hours. Jim Burke, the CEO of Johnson & Johnson pulled the product. Cost them $300 million or $400 million but it ultimately saved their product.

Compare that, for example, to the Exxon Valdez oil spill. Where was the CEO? Who was the CEO? Was he visible? Was he out in front? What was going on at Exxon? Bunch of operations research guys and finance guys were sort of analyzing the liabilities, but they didn't get out in front and deal with the problem.

So in some sense, values in organizations allow you to execute a whole bunch of not-discussable items. Johnson & Johnson, for example, had a corporate credo. Number one was, "We deliver quality products and services to our customers." Number two was, "We provide good jobs for our employees." Number three was, "We're a good corporate, socially responsible organization." Number four was, "We earn a fair return to our shareholders." And if those are your priorities, and everybody in the organization has kind of re-upped and agreed with them, then the quality products to your customers drive that immediate response.

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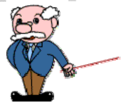

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So we're going to start with purpose as the corporate vision, values, and goals. Let's talk a little bit about these other two things.

Core competencies
Core competencies. I've got this as a corporate level strategic decision. Why? Well, just look at the error that Apple made. Basically Scully identified their core competencies: They were wonderful in desktop publishing. They were the world's best operating system. How did they use their core competencies? They used them to compete in the Macintosh computer business. They should have used it to get into the other 90 percent of the industry, which was driving all the value, which had all these structural changes taking place. But there was this cultural impediment to making that transition.

So you need to think about, at the corporate level, developing your core competencies and then leveraging them more broadly than the individual businesses within which they might have been developed.

Scope
And obviously the scope of a firm is decided at a corporate level.

Business unit strategy
But where you make your money is in business unit strategy. The three essential questions are, what resources does the company possess? What businesses should the company be in? And what's the role of the corporate office? That is, what are the structures, systems, and processes and how does the corporate center add value to the organization?

You'll see when we get into that discussion that there are many organizations that don't have an effective corporate strategy. Matter of fact, one of the tests is, is your breakup value worth more than your combined value? Does AOL Time Warner have a comprehensive corporate strategy? Well, the failure of that merger is probably due to the cultural impediments in the organization, because there were, before AOL acquired them, three warring camps. New York, Atlanta, and Burbank were the three warring camps, which were the Warner, the Turner Broadcasting, and the Time organizations. And they never captured synergy within those three businesses, so it was a Herculean assumption to have AOL think that they would acquire them and create all the synergy within that organization.

In any case, what we're going to talk about largely here is competitive strategy. And we're going to talk about one part of the problem, which is strategy formulation. We're not really talking about strategy implementation.

Your Changing World
So let's talk about your world. Your world is changing. Most of you are probably here because there are some fundamental changes taking place in your industry, so when you think about it, there are fundamental drivers of change in your industry. They may be globalization and technology, because those two things are affecting many industries. There also might be things like deregulation. If I look at the telecommunications industry on a global basis, the deregulation of the industry is as important as the technology issues that are driving it.

But there are fundamental drivers of your industry structure. It's changing your industry structure, causing you to formulate new competitive strategies, and often getting you to design new organizational forms. That's a problem for many organizations—the kind of organizational structure you're dealing with—because when you think about it, many of you have a traditional, hierarchical, formal organizational structure. But lots of the work takes place through networks of people kind of floating on top of that organization. And what we need is some better organizational theory on how to deal with this new organizational structure, which is sort of networks floating on top of a traditional functional hierarchy. In many organizations, most of the work is getting done in these networks of people, but you still have all these organizational requirements and meetings out of your traditional organization. When I'm talking to senior management in many companies I find that just getting on their radar screen to have a meeting with them is difficult because of the number of meetings that they're involved with. The concern is if these guys spend all their time in meetings, when are they ever thinking about what they're doing? Hopefully they are.

In any case, in this kind of world in your industry you might have some different drivers of change, but in many industries, technology is one, globalization is another. If you think about the pharmaceutical industry, you don't have information technology as playing so much of a role, but the whole human genome development is challenging the traditional drug development process. So you have the pharmaceutical industry built around the blockbuster drug model. Look at a company like Pfizer. I think it has more than ten drugs with more than a billion dollars in sales of each drug. I think 80 percent of their sales come from blockbuster drugs. And so you ask yourself, with this human genome technology for drug development available, what's that going to do? What's that going to do to the way drugs are developed and sold? When you think about it this human genome allows you to very much tailor the drugs to subpopulations with particular genomic characteristics, and that's an entirely different model than competing on $7 billion to $8 billion markets for Lipitor.

So you've got Pfizer completely geared towards this big blockbuster drug model, and yet the technology is allowing drugs to be developed that are very specialized, focused on specific diseases for people with specific characteristics. And we don't even know how they'll charge for drugs like that. Suppose you develop drugs that are highly tailored to specific diseases of a specific population. Will they be able to charge several thousand dollars per pill? What do you think? Strikes me is that it's a problem. Right? But the other thing that strikes me is that the traditional blockbuster model may not be sustainable going forward, because when you break out a new drug in a new category, it's quickly imitated, not by something that's exactly identical, but by a drug that serves exactly the same segment. So if you're thinking about high-cholesterol drugs, there are five effective high-cholesterol drugs in the same segment. Lipitor turns out to be an $8 billion version of that, but you ask yourself, "Can Pfizer continue to develop drugs with that kind of success rate?"

I'll come back to the issue about uncertainty, but uncertainty is clearly enormously important in some of this. And one of the reasons why many of you are here is to wrestle with the uncertainty that you're confronting within your industry.

Environmental Scanning
There are two fundamental questions in competitive strategy. The first one is, how structurally attractive is the environment in which I am competing? What are the drivers of structural change? Perhaps, what are scenarios for how my industry might look in the future?

So the first question is, how structurally attractive is the industry? What are the drivers of change? And that's to go after the second question, which is, how can my business be positioned or repositioned in my industry in order to sustain some sort of competitive advantage? So the theme of competitive strategy is creating some sustainable competitive advantage. But it turns out, in general, that firms don't sustain their competitive advantages for long periods of time. The number of firms you can pick out that have been at the top of their game for twenty or thirty years is pretty small.

Industry analysis
In analyzing your competitive position, you start by doing industry analysis, a la Mike Porter's five forces analysis, which we're going to modify slightly to add this role of complements. And so the question is, what are the drivers of change? What are the possible scenarios for my industry? So I'll do the five forces analysis to get a handle on what attractiveness the segment has, and then I'll look at my own strategy in that segment.

Let's talk a little bit about what makes firms more profitable. There is a lot of analysis on this. There are certainly some clear industry effects. Firms in terrific industries do better than firms in lousy industries. But in this historical data that I have here, that only explains about 16 percent of the profitability. So 16 percent of the profitability is explained, but this analysis comes from doing a bunch of regression analyses across industries in competitive positions.

There are a bunch of these variables that are attributable to industry differences and firms in better industries are, on average, more profitable. But the within-firm differences are essentially the strength of your competitive position within the industry. And a lot of the profitability is essentially described by the strength of your competitive position. So even industries that are lousy industries often create some very profitable players.

And the part that's labeled "other" is the part that statistics doesn't explain, which is all the fine management jobs you guys are doing. We can’t explain too much of it with this.

Some industries are just better than others. The pharmaceutical industry for forty years has had much higher returns than all of manufacturing. Why? Can you sketch a quick analysis of the pharmaceutical industry explaining why it's so attractive?

__: There’s demand for healthy products.

PROFESSOR BRADLEY: People want to be healthy. A lot of demand. Sure. They're differentiated. They're certainly not commodities. They're unique products. They're patented. There's intellectual property control. There are patented segments.

__: It's less susceptible to an economic downturn. People will discard other things, but they’ll take care of their health.

PROFESSOR BRADLEY: Absolutely. People are always going to take care of their health. Who pays in pharmaceutical? Insurance companies and governments, not the end user. What does the end user want? Best product, great healthcare. Someone else is paying. I’m selling patented products. What are the barriers to entry in this industry? They're high. There’s R&D, etc. No, they're not insurmountable. We’ve seen lots of biotech firms get into the industry in the last ten, fifteen years. A lot of biotech firms got into the industry, but if you think of the barriers to entry—most of the biotech firms sell their products through traditional pharmaceutical companies, who have this marketing machine for selling—there’s a big barrier to creating that kind of marketing machine.

We could do that whole analysis, but basically you'd conclude by doing that analysis that pharmaceuticals was a highly attractive industry compared to most industries.

Here's actually the distribution of industry profitability. So this is looking at return on equity across industries. So what are examples of lousy industries? We said pharmaceuticals is a pretty good industry.

__: Steel industry.

PROFESSOR BRADLEY: Steel industry. Lousy industry, right? It's negative maybe 1 or 2 percent. Are there any good players in the steel industry?

__: Nucor.

PROFESSOR BRADLEY: Nucor, in particular, is highly profitable, great stock price, done fine. So it doesn't mean that just because you're in a lousy industry there's no hope, but you'd better find some unique strategy for capturing value in that industry. So Nucor and Chaparral have done pretty well in this industry. Now, it turns out that more than 50 percent of the steel in the United States is now made in mini-mills. None of the big integrated iron and steel guys ever invested in mini-mills. It's a kind of disruptive technology in a Clayton Christensen sense, where serving the current customers, the technology never looked like the right investment for USX and Bethlehem Steel as they sunk into bankruptcy slowly over time. They never made the investment, where Nucor and Chaparral and all these other guys invested in the technology.

So steel is a lousy industry. What other industries are lousy industries? Airlines. Everybody's in the tank at the moment. Except that there were three years in the boom of the dot-com world when the airline industry was making money. But if you look at it over a fifteen-year period, it just doesn't make any money. And currently it's a total disaster. Why is it a total disaster? Structurally. If we did the analysis . . . . Why is it a total disaster?

__: The fixed costs are so high that if there is a drop in demand it just can't make it out.

PROFESSOR BRADLEY: And what's your ability to differentiate, to create a unique position? Actually, when it was originally broken up it was a perfectly competitive industry because you could move the capacity to any route that had a capacity shortage. So the airlines, then, after deregulation, constructed a strategy for dealing with this, which was they tended to monopolize a hub, so 85 percent of the takeoffs and landings in Pittsburgh are done on U.S. Airways. But it actually didn't lead to much security at all for the industry. It created some very odd pricing situations. So if you want to fly from Boston to Dallas, it costs . . . . Anybody know what it costs to fly from Boston to Dallas?

__: Six hundred to eight hundred dollars.

PROFESSOR BRADLEY: They must have just dropped the price a lot.

__: That’s with a Saturday stay.

PROFESSOR BRADLEY: Okay, with a Saturday stay. Okay, I believe that. Basically, the Boston-to-Dallas flight actually has a relatively high price. Boston to Houston is a much lower price. Why is that? Well, basically there are a lot of ways you've got to go through some intermediate city. There are lots of competing carriers that provide intermediate city connections. So those prices are very low. But Boston to Dallas on a nonstop flight is very high priced.

So why don't I just get a ticket to Houston and throw away the other ticket and go cheaper? The airlines retaliate against me by canceling my return reservation. So there's a kind of aggressive response to that. But it's a real indication of the sort of dilemma in the market. Most routes are highly competitive. The competitive routes are pretty aggressively priced. And now with the fall with this fixed capacity and the falloff in demand, these guys are just hemorrhaging. So we're having airline after airline go bankrupt, and we'll probably see some more of this.

We've been talking about the depressing side of things. What's the good side? What are great industries? We said pharmaceuticals was a pretty good industry. What are other good industries? Is your industry a terrific industry? Cosmetics and toiletries? Probably a very solid industry. Other industries that are good?

__: Basic consumer goods have done quite well over time.

PROFESSOR BRADLEY: You want to narrow the consumer goods?

__: Soaps, detergents, and the standard stuff.

PROFESSOR BRADLEY: Yeah, that kind of stuff. Right. That's been a good segment over time. But there's actually quite a wide distribution of industry characteristics and they tend to hold up for a reasonable period of time. Industries tend to have long-run structural characteristics that make them relatively attractive or unattractive.

Key questions
There are two key questions in environmental scanning: To what extent does an industry differ from perfect competition? Because essentially market imperfections create the opportunity to create a different positioning in the industry to capture value. So in the airline industry, there's not much of a way you can position yourself very differently. Or is there? Is there anybody profitable in the airline industry? Southwest. Right? So there are some positionings, even in lousy competitive industries, that are quite attractive. Southwest has been profitable every year, every quarter for thirty years. The industry, overall, is a big money loser.

The other issue is, who captures the value? Do suppliers or buyers appropriate returns? Personal computers. We have Microsoft and Intel appropriating $15 billion in returns, where the entire industry in its best year does maybe $5 billion. Do substitutes or prospective new entrants limit demand and/or profitability? In personal computers there are a whole bunch of substitutes, which may eat into the long-run demand in the industry. So that limits them to a certain degree. And does the intense competition kill the margins? Well, personal computers that are basically running 3 percent of the sales are the kinds of returns in the industry, basically selling commodity products, very price-driven—not a terribly attractive segment.

What we're going to suggest is that the first step in doing your strategy analysis is to do this environmental scanning. You ought to do it via this five forces approach. This approach has been around for twenty-two or twenty-three years. It's surprising that we're still talking about it. There aren't many strategy tools that have held sway for that long. This one has actually changed a little bit as we've got the sixth force, which I'll come to in a minute.

Future industry scenarios

But one of the things I said earlier was that the environmental uncertainty is kind of key in doing industry analysis and often you need to formulate alternative scenarios of how your industry is going to evolve. What I mean by an alternative scenario is an alternative logic for how your industry will evolve.

I don't mean that I've got my manager's best case and I'm doing some sensitivity analysis on the best case. What I'm thinking about for scenarios is an alternative logic to how my industry might unfold. And when I do scenario analysis I never use an odd number of scenarios. I always use two scenarios or four scenarios. Not three or five. Because if you use three scenarios, the scenario you really believe in is going to be the middle scenario. And then there'll be some sensitivity analysis on either side of the middle scenario. And you'll pretty much ignore what's coming out of that.

But if you put two scenarios down and you force people to wrestle with the uncertainty about which scenario is really true, you'll probably make some progress in getting people to internalize the scenario difference.

So the idea in doing scenario analysis is to get at the true underlying uncertainty, the true things where you don't know what's going to happen in the industry, and make them believable, absolutely believable, so you can internalize about the uncertainty.

Strategy in the face of uncertainty is quite different. Because if you pretty much know what the environment is going to do, you can agree on a strategy and be fairly comfortable with it. If you're facing a lot of uncertainty the choices are different. You could have a strategy that would hedge against the uncertainty. That's what most firms do: hedge against the uncertainty.

But it might be much more viable to bet on one of the scenarios, where you win big if that scenario takes place and you lose if it doesn't take place. And so, when you're faced with this kind of uncertainty, that's absolutely a plausible strategy. Hedging strategy in the face of technological change might be the wrong strategy. It might not get you committed to developing the technology to win if you're right.

So there's a real difference in the way you think about strategy when you're internalizing the uncertainty. Hedging is one. Betting on a scenario is another. Another one would be influencing what scenario actually takes place.

So the uncertainty analysis is an important part of this and probably developing a couple of alternative scenarios is the right way to think about it.

Drivers of change

There are always these drivers of change in an industry, which may come into your scenarios and may not. But the drivers of change may be external to your industry, like deregulation of the telecom industry. All the players in the industry didn't control the deregulation process; the deregulation process got imposed on them and then everybody had to react in that kind of environment.

Or it could be a function of competitors' strategy. So you have Wal-Mart in the discount retailing business following this absolute low cost strategy, this supplier relationship, etc., but that forced everybody in the industry to adjust their strategies to respond to Wal-Mart.

And then I mentioned disruptive technologies. Disruptive technologies essentially don't get adopted by the traditional players in the industry. The traditional players in the industry are looking closely at what their current customers' needs are; they're satisfying those needs very closely. Disruptive technology is when they come in, often with inferior products not acceptable to the current customers, and so they don't get picked up by the traditional players in the industry. And then they develop, like in the steel industry. When the mini-mills came in, they made rebar—reinforcing bars, the stuff you hide in concrete to reinforce it. So they made a bunch of that stuff. And then over time they moved up from one segment to another segment gradually, kind of improving what they did.

About 1990, Nucor got invested in something called thin-slab casting, which would allow a mini-mill, if it were successful, to get into rolling sheet steel. And so they were successful with that experimental technology and that drove the whole industry to produce more than half the steel from mini-mills. None of the traditional steelmakers invested in any mini-mill technology. They all kept with their integrated iron and steel stuff and never made the conversion.

Complementors and Competitors
So the first piece of this analysis is to analyze your industry position. Then you need to analyze your position with respect to a couple of other issues. One is complementors and the other is competitors. So let's talk about complementors.

Here's what's called the Value Net, comes out of some work by Nalebuff and Brandenburger. Nalebuff is from Yale; Brandenburger is from Harvard. But what's lacking on this diagram? "Substitutes" is lacking. It's got competitors; you could say "new entrants" are like competitors. But it's lacking substitutes, and that's really a mistake in this framework because substitutes are very different. Competitors cheapen what you do by increasing the supply of what it is you do. Substitutes cheapen what you do by decreasing the demand for what you do. So they're very, very different forces.

So this Value Net proposition came out as a way to analyze customers' willingness to pay, and what it's really done is highlighted the need for looking at the role of complementors. So if you think about the personal computer industry, what's the complement, what are the complements in the personal computer industry, to the operating system and hardware business? It's the software and the peripherals: the software, the great functionality and the decrease in the price; the peripherals, the switch to colored printers and the great decrease in price, all make the one really positive element of the personal computer industry. And it's the one element of the industry that Apple really can't take advantage of because they're not on the right platform.

The Business Model
So basically the issue is, you've done your industry analysis. The question is, given the industry structure, how does a firm outperform the industry average? Well, this slide has no information content on it, whatsoever; it's just to say that they've got to create some sort of sustainable competitive advantage. So what does that depend on? It depends upon the kind of business model. And you could think about the business model built around these five bullets.

- *Customer selection*

One is customer selection: Which segments do we serve and which do we choose not to serve? Strategy is as much about what you choose not to do as it is about what you do.

Now how many of you are precise about which customers you don't serve? If you haven't thought about which customers you're not serving, you probably don't have your strategy cleanly articulated, because in each segment there's a set of people that you probably don't want to be serving. It's interesting, in most financial service organization, you think about the large brokerage houses—Merrill, and Schwab, and people like that, and the guys who run mutual funds, like Vanguard and Fidelity—most of these guys simply segment by the size of the account. Now is that the right way to do the segmentation? Probably not. But you'd like to segment something by the lifetime value of the account, as opposed to the size of the account at the moment. So you would actually like to give some services to people in the long run who are going to be big asset players, but you've got to figure out some other characteristics to identify them by so that you can give them those superior services.

Okay, so customer selection is the first piece.

- *Value proposition*

The value proposition is next: what do we offer and how we'll be differentiated from the competition. You need to think about your business. Do you have a clear value proposition in your business? It's surprising how often in organizations, talking to the team, it's hard for them to articulate what's the real value of the proposition. So we'll come back to that.

- *Value capture*

Value capture. How are you going to make money?

- *Scope of activities*

What's the scope of activities? What activities do we perform? What's our relationship with our value net partners? Right now there's a lot of outsourcing going on. Firms are controlling fewer and fewer of the activities, and that's a complicated choice, on which ones you actually control and which ones you outsource.

- *Strategic control*

And so the last thing is strategic control, which is, how do we sustain our profitability?

Competitive Advantage

Okay, when you start looking at your own competitive positioning, you've got to look at what are the sources of competitive advantage that you have. We're going to be very stark about this, overly simplistic, but there are three critical sources of competitive advantage.

Lowest cost

Having the lowest cost position in the industry is a source of competitive advantage, being like Wal-Mart, or being a successful differentiator.

Differentiator

Sony. You think about the consumer electronics industry. How many consumer electronics firms actually command premium prices? Probably almost nobody, right? Sony is able to command a premium price. So they were the one guy in this industry with a reasonably large market share that's been able to command a premium price through product innovation, branding, quality, a number of things they've done. But they've set the standards and continue to get a premium price.

System lock-in
And then there's a different type of competitive advantage, which is what we'll call system lock-in. You think about Microsoft, where they have these huge market shares in operating systems, in browsers, in Microsoft Office, etc. The question is, is Microsoft effectively differentiated? Is it a low cost strategy? Can I put them in one of those categories? Probably some of my colleagues would put them in one of those categories, but I'm very uncomfortable with doing that because I kind of see Microsoft as different.

And they're in businesses where the vision that they have is, they're looking for businesses with 90 percent market share, not 30 or 35 percent market share. And they basically are in the business of setting standards and using their market power somewhat illegally to capture these market shares. But basically, if you think about operating systems, once you get to the shift where they're the winner in operating systems, it's pretty much unassailable. Now you might say Linux might be able to underbid and get some of that value. That is true. In segment after segment, though, in industries that have interesting characteristics, they tend to be winner-take-all markets. There are network effects. A single standard gets created and then the market tends to, at a certain point, tip over and go essentially 100 percent. And it's not obvious which industries are going to be this way.

So in Microsoft, operating systems, absolutely. In browsers, absolutely. Microsoft Office? Is it obvious that Office software should be a winner-take-all market? It seems to me odd that it came out that way. Microsoft was in a number two or number three position versus Lotus 1-2-3, versus WordPerfect. But when they bundled them in Office and the other firms chose not to bundle them in Office, they ended up capturing enormous value. Now it wasn't preordained that it should happen that way, had you been able to merge up WordPerfect and Lotus 1-2-3, and that almost happened. The merger fell down based on the senior management not being able to agree on who was going to control the merged entity. So they both viewed themselves as so powerful that they wouldn't relinquish control, and the merger never took place.

But I maintain that, had that merger happened, the two systems could have coexisted quite nicely and maybe even the other guys would have won.

Those are the three generic strategies that we have. And I put systemic lock-in in as kind of different than either differentiation or low cost.

Competitive scope
The other competitive advantage that you get comes from scope, which is, it is broad or narrow? And there are four dimensions of scope. It's sort of the product-customer pairs you sell to, how vertically integrated you are, what your geographic scope is, and the related businesses that you're involved in.

And if you think about Merck versus Pfizer, Pfizer was basically only in pharmaceuticals until it did the Warner-Lambert acquisition. And then they acquired Adams, which had candies, and Chiclets, and a bunch of other stuff. They've now sold off Adams after two years and they sold off a couple of other businesses also that didn't fit with their model.

And for several years it looked like Merck was equally viable with Pfizer, where Merck had forward-integrated into pharmacy benefit management companies and everyone else had failed in that. Now Merck is starting to talk about selling off that business. That business is for sale at the moment.

But basically, in many businesses, your competitive advantage is driven by the scope of your activities, and I'll come to some examples of how that works.

Both can lead to superior performance
In any case, both low cost and differentiation can lead to superior performance. Get the lowest cost strategy, and however prices are set in the industry, you've got a reasonable margin. Differentiation, the critical thing to think about is differentiation is basically selectively adding costs in order to charge a premium price. So differentiation is not about being different, it's about being able to charge a premium price.

Basically a low cost position is driven by the activities. All the activities in the firm have got to be lined up and on the same page and support this low cost position. In fact, we'll even go further than that. It's not just the activities in the firm, it's how you link to the other value chain players in your industry.

Mutually reinforcing activities
The other thing is, these activities all need to be mutually reinforcing one another. One thing about Scully's strategy that was wrong, when we think about Apple, is that he was simultaneously going for hit products, which were these differentiated, innovative products, and simultaneously going for low cost, high volume. And you ask yourself, the low cost, high volume was inconsistent with the differentiation and added costs of trying to create that differentiation.

Well, in effective strategies all the activities are lined up and aligned with one another. So this is Southwest, and you know what their model is: limited passenger service; point to point; low ticket prices; high aircraft utilization; frequent, reliable departures; lean, highly productive ground crew. And you ask yourself, what are all the supporting activities, which I've indicated here in green. Everything in Southwest is driven to be a low cost strategy. Now they're a union operation but the union is pretty flexible in terms of the work rules. So they're not constrained by the typical airline union that doesn't allow one specialty to do another specialty's activities.

So who cleans the planes on Southwest? Everybody. The crew. Before the crew gets off and makes the switch, they clean the planes out, as opposed to a separate crew going through and cleaning the planes. Now that would be totally impossible in American or Delta. So they have a union and they're actually paid well against industry average, but it's driven by the productivity of the whole operation. So their gate turnarounds are like fifteen minutes. Plane comes in, lands, is cleaned, unloaded, reloaded in fifteen minutes, maybe twenty, but the target is fifteen minutes. What's the typical turnaround of another airline?

__: Forty-five minutes.

PROFESSOR BRADLEY: Forty-five minutes would be fabulous. It’s more like an hour and fifteen minutes.

But the thing about the strategy, all of the strategy, all of the activities have got to be mutual reinforcing to drive the overall strategic positioning. And when you get companies operating in a mixed mode where they're trying to simultaneously be differentiated and low cost, that's when they tend to get into trouble.

How a firm affects buyer value
Okay, let's talk a little bit about how a firm affects buyer value. You either lower the buyer’s cost or you enhance the buyer’s performance, so you need to look at the buyer’s value chain and see how you impact them. So here's the idea. You need to look at every point at which you touch a buyer's value chain. It's not just about the product. It's not just about the service. It's the product. It's the service. It's the billing. It's every point of contact. Is your firm easy to do business with? Every point of contact with the customer is an opportunity to differentiate yourself.

Interrelationships
You need to think more broadly about the source of your competitive advantage than strictly your own value chain and your own proposition, because think about multibusiness firms. Often the competitive advantage in one business is driven because the firm is in another business. So this is diapers. Kimberly-Clark and Procter & Gamble are the winning diaper manufacturers, plus a bunch of private label guys. Johnson & Johnson was driven out of this industry about twenty years ago. Johnson & Johnson is *the* name in baby products, right? And they’ve got coupons on everything, the pink stuff and the oil.

So they put coupons on all these baby products for diapers, and you'd think they'd be able to sell a ton of diapers. But they failed in the market; they got to about 20 percent and they exited. And what they didn't understand was that P&G and Kimberly-Clark had other businesses that tended to drive the cost of the business. So one of the businesses they had was paper towels, which drove the logistics cost. Then they were in feminine hygiene products, which drove the R & D costs. And there were other related business that Kimberly-Clark and Procter & Gamble were in, which drove the cost structure of diapers. And even though Johnson & Johnson looked on the surface to be someone who ought to be a winner in that space, they ultimately got forced out of the space. So you need to take that into account.

Advantages driven through the system
And then there's another issue, which is the advantages often driven through the value system. Wal-Mart basically links up to the people who supply Wal-Mart. They work very hard at taking costs out of the whole value system, not just costs in their value chain. They have vendor-managed inventory programs with a number of their vendors. They have category managers by a number of their vendors. They go and consult with their suppliers to improve their suppliers' effectiveness of their operations. They give them fabulous data on this retail link system. Their whole model is to try to take costs out of the whole value chain. So, often when you're competing against a player, if you're just working your own value chain, you're missing that the player's advantage comes from a broader perspective, which is taking the costs out of the whole value chain.

Strategic Options
So you’ve analyzed your industry, you've analyzed the source of competitive advantage, and you need to look at your strategic options. Strategy is about searching for a unique position. It's not a race to the operationally efficient frontier.

Responding to Competition
Let's talk about responding to competitors. We talked about complementors and the role you had to take with respect to complementors. You also need to think about how you’re positioned vis-à-vis competitors, and we’re going to use this simple framework that I've got

illustrated here, which basically deals with, how do you analyze competitors? Let me just jump to that.

So these are the questions you need to ask and answer about competitors. One, is the competitor satisfied with their current position? What likely future moves or strategy shifts will the competitor make and how dangerous are they? Where is the competitor vulnerable, and what will provoke the greatest and most damaging retaliation by the competitor?

Now this is a different set of questions than you normally think about asking about your competitors. You normally think about it as being sort of geared to the details of competitor analysis. But what you really need to do in competitor analysis is to get into the head of your competitor and understand what they're likely to do. So we have a classic case we do in competitor analysis and it has to do with Sky Television in the U.K. versus the British Satellite Broadcasting Company. The British Satellite Broadcasting Company won a fifteen-year license to do satellite broadcasting in the U.K. Sky had been one of the bidders that bid against them, and they had lost the bid.

So British Satellite Broadcasting started hiring people and staffing up and moving into the Marco Polo House and other beautiful locations in London, when suddenly out of nowhere, Sky Television announced they were entering the market and they were coming out of Luxembourg and broadcasting in standard PAL format in the U.K. They didn't have a legal right to do this because the guy who had the legal right was the British Satellite Broadcasting Company. And the British Satellite Broadcasting guy said, "Gee, they caught us completely by surprise," because they hadn't spent any time analyzing their competitors. Had they gone and analyzed their competitors, they would have quickly figured out whether Sky Television was satisfied with its current position. Absolutely not. It lost the bid. It's an unhappy camper. Can it do anything?

What likely future moves or strategy shifts will they make and how dangerous are they? Well, maybe they'd try to get in. And the question is, would you get any insight into whether or not they'd try to get in? Well, if you actually looked at their history you'd see that when Sky lost a TV station in Sydney in its early years, it went outside of Sydney, turned the antenna around, and broadcast into Sydney. And finally the guy with the local Sydney license got so upset and he couldn't deal with this broadcasting from outside of Sydney into Sydney, so he basically took him on as a 25 percent partner. Rupert Murdoch as a partner is not a partner you may want, in any case.

Where is the competitor vulnerable? In Sky's case it probably had to do with their financial structure. They had just bought a big magazine business. And what will provoke the most damaging and greatest retaliation by a competitor? The question is what's the most damaging thing the competitor could do? Suppose Sky gets into your industry and gets in there first? That would be pretty damaging. And in fact that's what they did.

The way you think about this is, you analyze these four boxes about your competitor, the sort of left-brain side and a right-brain side. The left-brain side is the objective part—the resources and capabilities your competitor has. What's their current strategy? That's the part of strategy analysis you probably spend some time doing.

The right-brain side turns out often to be more important, where you're looking at their future goals and the apparent assumptions. So if you got into the goals of Rupert Murdoch and Sky Corporation, it would be basically to be a dominant media player, at least in English-language media. It would be hard to imagine he wouldn't be able to get it. And we knew from the corporate strategy that there was a commitment to TV and cable and satellite, and a move away from the newspaper business.

So the assumptions they were operating under were, if they could get in, they would probably not be forced out by the government. So the question is, if Sky could get into the U.K. market, even though they didn't have the license, they would probably not be forced out. The reason was, Thatcher was the government at the time. Murdoch's papers had all supported Thatcher, so if they would get in they probably would not get a lot of pushback from that.

So British Satellite Broadcasting had gotten Sky on their radar screen and done the competitor analysis, they would have been pretty nervous about them, and they could have taken a whole host of actions to keep them legally out. They could have gone to the government before they entered and gotten the government to agree to keep them out. They could have cut deals with the movie studios before Sky entered, at much cheaper prices, and they were just arrogant and didn't watch what was going on.

When Sky announced, the price of the movie deals went up, and Sky got in there first, and Sky basically ended up with a million customers to 175,000 for British Satellite Broadcasting. They merged these two entities and the entire British Satellite Broadcasting management structure, except for the vice president of finance, went away, and Sky became the controlling player.

Sustainability Analysis
So you've analyzed your competitors and you've got your strategy. The question is, is your strategy going to lead to a sustainable competitive advantage? And there are four risks you've got to analyze in looking at the sustainability of your competitive advantage. They are imitation, substitution, holdup, and slack.

Imitation is the risk we largely guard against. We look at what competitors are doing. We build barriers to imitation. So that one we're pretty good at.

Substitution is a little more insidious because it decreases the demand. So if I'm producing products and services, the demand is reduced because somebody else has got a substitute for this. You've always got this strategic decision: Do I enter the substitute? Do I defend with my current product? Do I harvest my business in light of the substitute? So you've always got that strategic decision. But it's a risk that many firms are less prepared to analyze. These two deal with supply and demand. One, the supply side cheapens my product because it creates more demand. The substitute cheapens my product or service by reducing the demand for it.

Then holdup and slack deals with who captures the value and whether or not there's value really created. So holdup is, I'm partnering with some people in the value net, i.e., I was partnering with Microsoft and Intel in the personal computer business. They're capturing $15 billion worth of returns. The industry is capturing five. They basically have got a gun in our ribs. Classic holdup. They capture all the value.

Think about this. When IBM went down the path of partnering with Intel and Microsoft, they had no idea they were going to lose control of the industry. They intended to take back control of the chip; they intended to take back control of the operating system. They launched OS-2 as their operating system, which didn't ever play, and it finally got terminated by Gerstner. They were a semiconductor leader and they were planning to get it on their own chip. They were unable to do those things.

Often you end up partnering with people over time in which you're not successful. They end up holding you up and capturing the value. Think about all the strategic alliances your company has now. Did you really sort out those strategic alliances to know that you were kind of insulated from being held up down the road? Probably not. IBM certainly planned not to be.

Slack is organizational inefficiency. The idea is that you don't capture the value that's there because your costs are basically out of line. And there's a terrific example of this from the early ‘80s, which was Xerox in the copier business. Xerox was improving its copy costs at about 10 or 11 percent a year, and thought they were doing fine. Canon and other Japanese guys came in against them. And Xerox was fortunately able to do competitive benchmarking because of their 50 percent interest in Fuji Xerox. Fuji Xerox, a Japanese company, was able to go in and benchmark all their products. They basically did a benchmarking study and told the corporate guys at Xerox what the result was, and they found out they were at a 50 percent unit manufacturing cost disadvantage. They were producing two products a year with 4,000 guys and the competition was producing four products a year with 2,000 guys.

And they benchmarked on everything that they could do and basically they discovered, "We're in terrible shape." So Xerox did an enormous restructuring. And Pankaj Ghemawat calculated that they saved $2 billion of cash flow per year by this restructuring. They did it because they were in a crisis. But those $2 billion could always have been taken out. They did it when they found out that they were in this terrible competition with the Japanese guys and they were in crisis. And then they identified it and took out the $2 billion. But that's what happens to industry-leading firms that aren't really benchmarking and comparing. They don't actually know that their costs are way out of line.

So this is the idea that you don't capture the value that's there because just your costs are out of line. And there are some tricky issues about how do you get the incentives right, and that sort of thing.

Strategic Innovation
Now in any strategy approach you've got to be dealing with sort of an innovation aspect, and let me just give a couple of bullets. You need to create active programs for business innovation. So one problem with strategy is fixing on executing a strategy and having this core competency, having all your strategy lined up, where you need to do running a bunch of in-market experiments. You need to be experimenting with disruptive technologies. You need to be doing a whole bunch of things that are kind of hedging the bets of your strategy.

So this slide is basically to emphasize the role of that innovation. You've got to have an innovative part of your organization that creates these opportunities so that your core competencies today don't become your core rigidities of tomorrow. So you don't get so locked in to those rigidities.

Strategic Implementation
You've got to decide and implement. You've got to identify the valuable corporate resources, invest in the resources, leverage the resources, and upgrade the resources over time. This is the kind of thing that Apple didn't do. It basically focused all on its single business and didn't leverage its resources more broadly in the marketplace, for one.

Competitive Strategy Development
So at the end of this talk I've put in seven steps that you might use in a strategy analysis process. So if I take what I've been talking about and hit these points, environmental scanning is step one. You can call it anything you want. We're not particularly wedded to one—you don't have to do five forces analysis. But everybody does some variation of this kind of industry analysis.

Second piece is customer analysis, which is market segmentation, customer's value chain, and value proposition. I ask is your value proposition clearly identified?

Third piece would be competitor analysis. And these are the steps in any competitive analysis; you'd need to do those. And then here are the other four steps: Strategic alternatives—getting real alternatives with unique sources of competitive advantage—the sustainability analysis, strategic investment, and implementation.

Summary
Great companies have a vision of how to compete. Great companies exploit clear competitive advantages. Great companies provide real customer value, influence the environment, and great companies continuously innovate, cannibalize their own success, and reposition their assets**.**